No. 21081

IN THE

# United States Court of Appeals

FOR THE NINTH CIRCUIT

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HENRY ROY,

*Appellant,*

*vs.*

UNITED STATES OF AMERICA,

*Appellee.*

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On Appeal From the Judgment of the District Court of the United States, Southern District of California, Central Division.

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## APPELLANT'S OPENING BRIEF.

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### Statement of Jurisdiction.

This is a criminal action brought by appellee, the United States of America against the appellant, Henry Roy, for willfully attempting to evade and defeat a part of his Federal income tax liability for the calendar years 1958, 1959, and 1960, in violation of Section 7201 of the Internal Revenue Code of 1954, as amended. [Clk. Tr. pp. 2-5.]

Jurisdiction was present in the United States District Court of Southern California by reason of Title 18, United States Code, Section 3231, and Rule 18 of the Federal Rules of Criminal Procedure. On or about May 2, 1966, the United States District Court for the Southern District of California convicted the defendant on all three (3) counts as charged.

The appellant timely appealed to this Court. [Clk. Tr. pp. 27-28.] This Court has jurisdiction of the appeal under Title 28, United States Code, Section 1291, 1294(1), and Rule 37(a) of the Federal Rules of Criminal Procedure.

## Specification of Errors.

The Court below erroneously entered the judgment of guilty and denied the appellant's motion for new trial or a judgment of acquittal for the following reasons:

1. The plaintiff erred in its use of the bank deposit method of computing the appellant's taxable income by reason of the fact that the plaintiff had not established the inadequacy and inaccuracy of the defendant's books and records—a condition precedent to employing an alternative method of computing taxable income—when the use of taxpayer's books and records was the most accurate manner for ascertaining defendant's taxable income.
2. The appellee failed to introduce sufficient evidence to sustain a finding of willfulness on the part of the appellant within the meaning of Title 26, United States Code, Section 7201.

## Statement of the Case.

On April 7, 1965, appellant was indicted for violation of Section 7201 of the Internal Revenue Code of 1954 as amended. [Clk. Tr. pp. 2-5.] The indictment charged that appellant understated his taxable income by $81,887.60, $113,861.07, and $158,535.21 for the calendar years 1958, 1959, and 1960, respectively. This understatement, the indictment charged, resulted in an

additional Federal income tax liability for the above years in the amount of $52,206.39, $77,182.73 and $115,497.70. The alleged omitted income was determined by the Government on the bank deposit method of computing taxable income.

Appellant plead not guilty to all three (3) counts of said indictment and was tried by the United States District Court for the Southern District of California, sitting without a jury, on March 15, 16, and 17, 1966. The Court found the appellant guilty on all three (3) counts of the indictment. [Clk. Tr. p. 27.] Thereafter, the appellant timely moved for a new trial, or in the alternative for a judgment of acquittal. [Clk. Tr. p. 8.] These motions were denied by the Court. From this adverse decision, the defendant appeals to this Court.

The appellant contends that the evidence produced at the trial of this case was insufficient to sustain a judgment of conviction on all three (3) counts of the indictment, that there was insufficient evidence of willfulness within the meaning of Section 7201 of the Internal Revenue Code of 1954, and that the bank deposit method of computing taxable income was improper in these circumstances.

## ARGUMENT.

### I.

### BANK DEPOSIT METHOD—BOOKS AND RECORDS.

#### A. Case Law.

##### (i) Holland Case.

The appellee erred in its use of the bank deposit method of computing appellant's taxable income for the reason that appellee had not established the inadequacy or inaccuracy of the defendant's books and records, which is a condition precedent to employing an alternative method of computing taxable income. The use of the defendant's books and records would have been the most accurate manner of ascertaining defendant's taxable income.

Prior to 1954 the case law was unclear when considering the use of circumstantial evidence to establish a tax deficiency, and the accompanying fraudulent intent. The circumstantial evidence was presented through recomputations of taxable income by use of the net worth and bank deposit methods. The conditions precedent to the use of those methods, and the evidentiary value of same, had been the object of court decisions which varied greatly in allowing the use of such evidence. The conflict was presumably resolved by the decision of the Supreme Court in *Holland v. United States* (1954), 348 U.S. 121, 75 S. Ct. 127. The Court first noted at pages 124, 125:

> "In recent years, however, tax-evasion convictions obtained under the net worth theory have come here with increasing frequency and left impressions beyond those of previously unrelated petitions. *We*

*concluded that the method involved something more than the ordinary use of circumstantial evidence in the usual criminal case.* Its bearing, therefore, on the safeguards traditionally provided in the administration of criminal justice called for a consideration of the entire theory.

. . .

In a typical net worth prosecution, the Government, *having concluded that the taxpayer's records are inadequate as a basis for determining income tax liability,* attempts to establish an 'opening net worth' or total net value of the taxpayer's assets at the beginning of a given year." (Emphasis added.)

The Court then considered the policy considerations on which its holding was based (pp. 125-126):

"Before proceeding with a discussion of these cases, we believe it important to outline the general problems implicit in this type of litigation. In this consideration we assume, as we must in view of its wide spread use, that the Government deems the net worth method useful in the enforcement of the criminal sanctions of our income tax laws. *Nevertheless, careful study indicates that it is so fraught with danger for the innocent that the courts must closely scrutinize its use.*

"One basic assumption in establishing guilt by this method is that most assets derive from a taxable source, and that when this is not true the taxpayer is in a position to explain the discrepancy. The application of such an assumption raises serious legal problems in the administration of the criminal law.

> Unlike civil actions for the recovery of deficiencies, where the determinations of the Commissioner have prima facie validity, the prosecution must always prove the criminal charge beyond a reasonable doubt. This has led many of our courts to be disturbed by the use of the net worth method, particularly in its scope and the latitude which it allows prosecutors. (Citations)." (Emphasis added.)

The Court, on pages 127 and 128, then analyzes the dangers encountered in using circumstantial evidence:

> "This leads us to point out the dangers that must be consciously kept in mind in order to assure adequate appraisal of the specific facts in individual cases."

The Court then lists six (6) such dangers. In Item No. 4, the Court states:

> "When there are no books and records, willfulness may be inferred by the jury from that fact, coupled with proof of an understatement of income. But when the Government uses the net worth method, and the books and records of the taxpayer appear correct on their face, an inference of willfulness from net worth increases alone might be unjustified, especially where the circumstances surrounding the deficiency are as consistent with innocent mistake as with willful violation. On the other hand, the very failure of the books to disclose a proved deficiency might indicate deliberate falsification."

The Court then considered the facts at hand (pp. 131-132):

> "Petitioners' accounting system was appropriate for their business purposes; and, admittedly, the

> Government did not detect any specific false entries therein. Nevertheless, if we believe the Government's evidence, as the jury did, *we must conclude that the defendants' books were more consistent than truthful, and that many items of income had disappeared before they had even reached the recording stage.* . . . To protect the revenue from those who do not render true accounts the government must be free to use all legal evidence available to it in *determining whether the story told by the taxpayer's books actually reflects his financial history.*" (Emphasis added.)

The *Holland* case was both restrictive and liberal in setting standards to be followed in determining taxable income through the introduction of circumstantial evidence. The Court clearly states that the Internal Revenue Service may use circumstantial evidence in cases other than where the taxpayer has no books, or where his books are inadequate (p. 131). What the Court in reality said is that the net worth method may be used to establish the fact that the taxpayer's books are inaccurate; consistency on its face cannot be equated with accuracy. However, the Court was restrictive in that it set limitations on the use of the net worth method, and throughout the opinion stated that the use of circumstantial evidence in a tax case creates many dangers for the taxpayer.

Circumstantial evidence is normally received but viewed with distrust. In a tax evasion case under 26 U.S.C. 7201, the Court in *Cohen v. United States* (5th Cir., 1966), 363 F. 2d 321, 327, stated:

> "The circumstances proven must lead to the conclusion with reasonable certainty and must be of

such probative force as to create basis for legal inference and not mere suspicion, *Wesson v. United States,* 8th Cir., 1949, 172 F. 2d 931. In the absence of direct proof, the circumstances relied upon to sustain a conviction must not only be consistent with guilt, but inconsistent with every reasonable hypothesis of innocence. *Barnes v. United States,* 5th Cir., 1965, 341 F. 2d 189."

This Court set aside a perjury conviction in *Whaley v. United States* (9th Cir., 1966), 362 F. 2d 938, 939, and stated:

"While circumstantial evidence may support a conviction, it must be adequately sufficient to enable a reasonable determination that it excludes every hypothesis except that of guilt."

**(ii) Riganto Case.**

In the case of *United States v. Riganto* (D.C. Va., 1954), 121 F. Supp. 158, the Court carefully considered the applicability of the bank deposit method in establishing an understatement of income. The Court noted, at page 159:

"In the last few years I have observed with interest a change that has taken place in the nature of proof offered to support the charge of the prosecution in many of these cases charging tax fraud. This change has caused me some concern by what appears to be a *preference to introduce proof to show understatement of income and fraudulent attempt by methods other than by direct evidence.* Of course, it is necessary in some cases that the Government procede by indirect methods. This evidence consists of proof undertaking to show in-

come of the taxpayer computed upon what is referred to as the net worth increase or bank deposits and expenditures methods, or a combination of both. The latter is employed here. Basing my observation upon a number of cases during the past few years, *it would seem that the use of one or both of these methods has been employed through preference at times when direct evidence is available.*" (Emphasis added).

At page 161, the Court holds:

"As I stated a while ago, the Commissioner has discretion to use a method other than the bookkeeping method regularly employed by the taxpayer only when the method employed by the taxpayer does not clearly reflect the true income. I have heretofore ruled, and I adhere to that ruling, that the burden is upon the Government to show, before resorting to another method, the inadequacy of the books and records employed by the taxpayer. The Government must also show that the net worth method, the bank deposits method, or whatever other method is adopted, does reasonably reflect the income of the taxpayer. In meeting that burden, the Government must introduce evidence, other than its own computation, *to discredit the books and records of the taxpayer, such as proof of unrecorded transactions, or internal evidence within the books themselves showing incompleteness or inaccuracy.*" (Emphasis added.)

Appellant contends that the *Riganto* case, *supra* is sound in its rationale. It is true that the Supreme Court diluted the holding of Riganto somewhat in *Hol-*

*land v. United States, supra,* at page 131. However, *Holland* did not reject the contention that, where there was no evidence of the insufficiency or inaccuracy of the books and records, as here, the use of the net worth method would be improper. The *Holland* case stated that the Government may go outside the books themselves to *discredit the books.*

All of the case law cited herein, and that anticipated in the Government's reply to this brief, are consistent with the theory propounded by appellant. The net worth method may be resorted to by the Government in order to establish the *inaccuracy* of the taxpayer's books and records. The fact that the books and records are consistent with the tax return does not, in and of itself, deprive the Government of the use of the net worth method. The courts recite the above statement of law in virtually all cases where the *books and tax return are consistent but incorrect.* The courts dwell upon the veracity of the books and records, not the tax return. Thus, even in the *Holland* case, the Court holds that the net worth method may be used *to demonstrate that the books and records are inaccurate,* and *then* holds that the net worth method may be used to compute the defendant's taxable income.

In this case we have the near-incredible fact situation in which the books and records have not been challenged, and in all probability are correct. The issue before the Court is whether the adequacy and accuracy of the taxpayer's books and records may be acknowledged by the investigating agent, thereby permitting him to directly ascertain tax liability through the use of circumstantial evidence, *i.e.* the net worth or the bank deposit method. Appellant urges the Court to reject

that test, and hold that the Government must prove the inaccuracy of taxpayer's books and records before it may prove its substantive case through introduction of circumstantial evidence.

**(iii) Dual Purpose of Bank Deposits Method.**

In the case of *Schwarzkopf v. Commissioner of Internal Revenue* (1957), 246 F. 2d 731, 733-734, the Court of Appeals for the Third Circuit correctly interpreted the *Holland* case, *supra,* and established a two-fold use of circumstantial evidence:

> "This quoted portion of the *Holland* case is recognized by petitioner as sanctioning the use of the net worth method to test the accuracy and completeness of the books of account. *Thus, the net worth method serves two purposes: First, it may be used to test the correctness of the books; secondly, it is cogent evidence of the amount of income which went unreported.* The fact that the books on the face appear to be adequate does not preclude the use of the net worth method. *Holland v. United States*, supra, 348 U.S. at pages 131-132, 75 S. Ct. at page 133. In any event, the books involved here contained items of net income with hospital expenses already deducted. The disposal by the taxpayer of bills evidencing these expenses made the computation of their amount impossible, and thus left vague and unreported some unknown amounts of income. The taxpayer's practice of cashing checks representing his patients' fees and receiving the money in large denominations rather than depositing the checks themselves made it impossible to test the accuracy of the books from that source. If taxpayer's contention is correct, every-

> one could keep a set of apparently accurate books, carefully destroy other evidences of the source and amount of income, and defend by an alien rule that the net worth method may not be used in those circumstances—and thus the government could be defrauded with impunity. *However, it is when other methods of disclosing income fail, that the net worth computation becomes especially important in the collection of revenue.*" (Emphasis added.)

The above quoted rule regarding the dual purpose of the net worth method, *i.e.,* to test the taxpayer's books and records, and secondly, to serve as evidence of unreported income, was approved in *Hoffman v. Commissioner of Internal Revenue* (3rd Cir. 1962), 298 F. 2d 784, 786. Appellant believes the above stated rule directly reflects the viewpoint of the Supreme Court as expressed in the *Holland* case, *supra.* It is consistent with the warnings found throughout *Holland.* The philosophy expressed is that an apparently accurate and consistent set of books and records shall not frustrate the Government's attempt to show that income has been understated. The Government may use the net worth method, or any other method constituting circumstantial evidence, first to disprove the *accuracy* of the taxpayer's books and records. Once the books are demonstrated to be inaccurate, said method of circumstantial evidence may be used to *approximate* the taxpayer's taxable income.

The above stated rule has been expounded upon on numerous occasions by the Tax Court. In *Ruth N. Bishop* (1962), T.C. Memo 62-146, the Court stated:

> "The right of respondent to resort to the net worth method is not dependent upon finding first (and

without regard to the implications of the net worth computation) that petitioners' books and records were not sufficient to properly reflect income. It is quite possible that even though a taxpayer may have a complete set of books and may employ a method of accounting which is capable of accurately reflecting the taxpayer's income, there may be false or incorrect entries made on his books, such as nonbusiness expenses, omission of cash receipts, and the like. In *Estate of W. D. Bartlett,* 22 T.C. 1228 (1954), we held that where the taxpayer presents a set of books and records which appear to be superficially adequate, the so-called net worth method may be resorted to and applied as a technique for disclosing a substantial gap between actual income and reported income, *and thereby suggest untrustworthiness of the books as a whole.* See also *Morris Lipsitz,* 21 T.C. 917 (1954), affd. 220 F. 2d 871 (C.A. 4, 1955), certiorari denied 350 U.S. 845 (1955)." (Emphasis added.)

In *Estate of Joe Wright* (1963), T.C. Memo 63-088, the Court stated:

"In any event, it is well established that the net worth method may be used even though a taxpayer maintains a set of books; *that such method may be used to test the accuracy of the books and the returns; and that when properly employed, such method may show that the books are not trustworthy. (Citations).*" (Emphasis added.)

A similar statement is found in *Julius Godeny* (1963), T.C. Memo 63-324:

"Petitioner contends that he kept adequate books and records for the years here involved and that

> the respondent was not justified in computing unreported income for this period by using the net worth method. Petitioner's contention is without merit. Where a net worth computation shows increases in net worth greater than that reported on a taxpayer's return, or is not consistent with his records, then the net worth computation is evidence that there is unreported income and *that the records, though seemingly complete on the face, are adequate, inaccurate or false.*" (Emphasis added.)

**(iv) "Most Accurate Method" Test.**

Appellant contends that, considering the dangers encountered in prosecuting taxpayers based upon circumstantial evidence, the investigating agent should be required to use that method for determining income which will most accurately reflect, or, if necessary, reconstruct the taxpayer's income. Appellant will demonstrate below that *all* income was reflected in his books and records, and that the Government agents, for reasons unknown to appellant, chose to reconstruct his taxable income by the use of the bank deposits method. It will also be shown below that the use of this method has not avoided all possibility of double inclusion of bank deposits, and eliminated transfers between banks. Under the circumstances of this case, it is clear that the most accurate method for determining appellant's taxable income for the years in question is through the use of the books and records maintained by appellant contemporaneous with his business transactions.

In the case of *Grace O. Dean* (1955), T.C. Memo 55-217, the Court disapproved of the use of the bank deposits methods, and noted:

> "It is true that petitioner's records were not maintained in an approved manner. They were apparently incomplete and in the circumstances the respondent in his determination was justified in adopting some method which would as nearly as possible correctly reveal petitioner's taxable income, if any. *The absence of complete recorded entries, however, does not justify his ignoring the obvious or excuse a failure to weigh and consider objectively the information and data which is supplied or otherwise available to him.*" (Emphasis added.)

In the case of *W. L. Harris* (1948), T. C. Memo 48-235, the Court concluded that the use of a variation of the bank deposits method was improper:

> "We deem it unnecessary to discuss at length each year from 1919 to 1937, inclusive. During that period (in 1925) the petitioner's records were burned. He had records of the monthly income from his practice thereafter and from October 17, 1928, *he has maintained card records of his patients. He stated, 'I have a record of every patient I wait on, what I did and how much I collected.' The agent was informed of the card system and the petitioner offered to show him any records at any time. The agent arbitrarily termed these records 'inadequate' and declined to employ them.*" (Emphasis added).

In *Blackwell v. United States* (8th Cir. 1957), 244 F. 2d 423, 427, 428, the Court stated:

> "In our present case, as previously stated, the defendant preserved only monthly totals of his cash sales. The memoranda upon which the monthly totals were based were not available for checking. The investigation also disclosed that the total deposits exceeded the total receipts. It is true, as defendant contends, that if his books were accurate and complete they would reflect his entire income. There is substantial evidence of an increase in defendant's net worth during each of the years involved in an amount considerably in excess of his reported net income. Defendant's explanation of this increase is the hoarded cash which he placed in the business. If the Government has proven that defendant did not have this hoarded cash, then the only source for the increased net worth above the reported income would be the defendant's furniture business. The Court, several times in its instructions, advised the jury in effect that, *if defendant's records reflected substantially all transactions of importance on the question of income, such records are the best evidence, and in that event the Government could not establish income by the net worth method. The evidence presented a fact question for the jury on the adequacy and truthfulness of defendant's records.*" (Emphasis added.)

Also worthy of note is the Court's statement in *Merrit v. Commissioner of Internal Revenue* (5th Cir. 1962), 301 F. 2d 484, 486:

> "The petitioner asserts that this case is not one calling for the application of the net worth method of determining income because adequate records were kept. *If the records of the taxpayer are inaccurate or incomplete the Commissioner may look to other information to determine whether the tax payable has been correctly returned by a taxpayer.* (Citations). Although the petitioner engaged the services of a bookkeeper in 1945, the entries in the books were only of such items as were reported by the petitioner to the bookkeeper. It was clearly established that much vital information was withheld by the petitioner from the bookkeeper. The net worth method was properly invoked." (Emphasis added.)

In their extensive research, counsel for appellant have been able to find but one case in which the taxpayer's books and records were inconsistent with his income tax return. In *Moore v. United States* (5th Cir. 1958), 254 F. 2d 213, the taxpayer claimed that his books and records were in fact inaccurate, and that the net taxable income as shown on his income tax return was in fact correct. The Government attempted to prove its case by basing its understatement of income on the discrepancy between the books and the tax return, claiming that the books reflected taxpayer's true income. They prepared a net worth statement as corroboration and as rebuttal to the defendant's argument that his books did not correctly reflect his taxable income. Fraudulent intent was demonstrated through the testi-

mony of taxpayer's accountant, who related how taxpayer arbitrarily instructed him to adjust the income from his books in preparing his tax return, and his direct admission to the accountant acknowledging that he was falsifying his return. Contrast that method of proof to the manner in which the Government presented the case now before this Court.

### B. Evidence as to Defendant's Books and Records.

The evidence outlined below will show the following facts: The defendant's records were maintained by his secretaries and by his nephew, Henry Oppenheim. The secretaries maintained books in which they listed the total amount of the recovery awarded for each client. This record was maintained for the purpose of assuring that each award was sent to the defendant, and in effect constituted an accounts receivable journal. Each girl also maintained a cash receipts book wherein she listed the amount of money received, and the amount still owed on account. Individual account cards were kept for each client. They stated the amount to be received, noted the subsequent costs incurred, and monies collected. The testimony indicates that none of these records were ever destroyed, that they were kept in the ordinary course of business, served as the financial records for the business, and that none of these records were ever requested by the investigating agents.

The testimony describing the defendant's books and records came from three employees. Magdelena Lewin was employed by the defendant during the entire period covered by the indictment [Tr. p. 64], as was Margot Baerlein [Tr. p. 180] and Henry Oppenheim [Tr. p. 464]. Mrs. Lewin testified as to the general business

procedure for handling the awards from Germany. In many cases there was a corresponding attorney in Germany. The defendant would write a letter to the German attorney, authorizing him to deduct his percent of the fee, and also directing him to place a 6% fee in a German bank for Mr. Roy. The net amount would then be transferred to the United States [Tr. p. 81.] The tenor of the transcript indicates that it is the fund retained in German banks for Dr. Roy which created the evidence relied upon by the Court in determining fraudulent intent. There were also payments of fees made directly to Dr. Roy in cases where there was no corresponding German attorney, or where the awards were paid directly to the client. The transcript indicates that these amounts were either reported on the appellant's tax return, or were disclosed to the revenue agent at the inception of his initial meeting with the taxpayer. The following is an analysis of how these transactions were reflected in the appellant's books and records.

1. *Book Detailing Awards.* Appellant's secretaries maintained books which in fact constituted an accounts receivable journal. This book is described by Mrs. Lewin on page 92 of the transcript. She states that a letter would come from the compensation office notifying Mr. Roy of the award. Mrs. Lewin states:

> "and then I wrote it down in a book for each individual client, he would receive so-and-so much, *and that some fee for Mr. Roy was already deducted. I put this also in this book.*"

In Transcript pages 93-95 Mrs. Lewin is questioned as to letters from the corresponding attorneys wherein said attorneys stated that they had deducted 12% of the award, 6% for themselves and 6% for Mr. Roy, and

were in the process of forwarding the net award. At Transcript page 95, Mrs. Lewin was asked if she came in contact with those letters to make further records from them, and she responded:

> "Yes, I received the statement when somebody received an amount because I had to put this in a particular book."

In further describing the book [Tr. pp. 96, 97], Mrs. Lewin stated that when the statement arrived as to what a particular client would receive, she would enter the name of the client, and the amount of the award. She also states [Tr. p. 97]:

> "And the amount, and when the fees were deducted in Germany, I would write down so-and-so much fees were deducted by the lawyer in Germany, and that he—and that from this amount Mr. Roy received so-and-so- much."

When the bank deposit slips arrived from the German bank, the amount of the deposit would be checked against the amount listed in the record of fees retained in Germany. [Tr. pp. 98-99.]

Mrs. Lewin further described the award book on cross-examination. Said book was identified as defendant's Exhibit "B" for identification purposes and presented to Mrs. Lewin. She stated that the book was mostly in her handwriting and that:

> "This book means that when a client receives funds from Germany—I mean when Mr. Roy received notice that the client will receive funds, then I enter the name of—the date of the letter and the name of the client, and the amount which the client will receive." [Tr. pp. 163, 164.]

On page 166, in response to the question, "Well, may I suggest that one of the purposes of Exhibit 'B' was to keep a control over awards awarded but not yet paid?", the witness's response was, "That is true." The award book was a log or an inventory of what was outstanding but not yet received.

2. *Cash Receipts Book.* At pages 161-163 of the Transcript, Mrs. Lewin described the cash receipts book:

> "Each girl had her book in which they entered the fees which were received on the particular day."

Defendant's Exhibit "A" for identification was one such book. The cash receipts were then transcribed to individual client's accounts.

Mr. Oppenheim further amplified the use of the cash receipts book:

> "Well, my duties were to see each girl kept their own record book, you know, the books that they transact during the day, in the work that they have done. And it was my duty to transpose those items in these cards that we have here." [Tr. p. 465.]

He then identified defendant's Exhibit "A" for identification as the girl's book that he had referred to.

3. *Account Client Cards.* Mrs. Lewin indicates that each individual client had a client file, and an open account card. As checks came into the office there was an attachment stating which client the check pertained to. A girl in the office would pull the account card and file for that client, and take them to Mrs. Lewin. Mrs. Lewin then took the account card into Mr. Roy. The

file indicated what the agreed fee was and the account card listed the receipt of the award and the expenses pertaining to the client. Mr. Roy then indicated what sum should be mailed to the client. [Tr. pp. 102, 103.] The checks received from Germany would be deposited in a trustee account at Security Bank or Bank of America. [Tr. p. 104.] Mrs. Lewin later states on cross-examination, that the cash receipts figures from the cash receipts book were transcribed to each client's open account. [Tr. pp. 161, 162.] She identified defendant's Exhibit "C" for identification as such an account card. As each check was received, it was entered on the account card. [Tr. p. 165.] The account cards were kept in Mr. Roy's offices, and accessible to everyone in the office. [Tr. p. 167.]

Mrs. Baerlein testified that the account cards were maintained for each and every client, that she could not recall any instances in which a card was not made out for a client, or of any instances where cards were destroyed. [Tr. pp. 202-204.]

Mr. Oppenheim testified that he would transcribe the information from the cash receipts books to the account cards:

> "Manually I would put down the date that the person really was in the office, the customer, and I'd put down the amount that was written, you know, the amount, the letter, and so forth, the amount and the new balance. That is all the transactions I did." [Tr. p. 466.]

Mr. Oppenheim also testified that to his knowledge, no account cards were ever destroyed or missing. [Tr. p. 467.]

## C. Agent's Investigation of Available Books and Records.

It is clear from the Bill of Particulars, plaintiff's Exhibit 69, and the general tenor of the transcript that the Government has used the bank deposit method for reconstructing income. Special Agent James P. Donley testified to that effect. [Tr. pp. 343, 344.] Appellant has described above the books and records which contain all of his gross receipts, both those reported on the tax return, and those which were omitted. What use did the investigating agents make of those records, and to what extent did they use them to establish unreported income?

In reviewing the testimony of Agent Donley, it is clearly demonstrated that the *only records* that were ever requested by the Government were those from which the agents would be able to reconstruct the figures shown on the income tax return. [See for example Tr. p. 279.] Counsel has been unable to find one statement in the entire transcript in which the investigating agents state that they asked for all records which would show the total amount of awards, receipt of all fees, both within the United States and abroad, or any other record from which to compute the defendant's *actual income*. The intent of the audit as expressed to the defendant by Agent Donley was a desire to reconstruct the income as shown on the tax return, rather than attempting to ascertain the total amount of awards received by the defendant's clients, and the fees received from those awards. It is apparent that the investigating agents were aware of the fact that there was technically unreported income (this fact was made known to Agent Breese at the in-

ception of his initial interview with the defendant [Tr. pp. 210, 211]), and were attempting to reconstruct which specific items of receipts were unreported so as to ascertain fraudulent intent. [Tr. p. 276.] The agents never asked for the records which would disclose taxpayer's true income, and never attempted to determine the existence of same.

Revenue Agent Charles Breese stated that he was given a tour of Mr. Roy's office, and that he viewed numerous files and file cabinets. [Tr. p. 214.] At the same time, he was given the cash receipts book and made a few preliminary notes of some of the figures contained therein. Mr. Breese stated that he saw the filing cabinets, but did not ask to review their contents or inquire into same at any time. He also stated that he was familiar with the client's account cards. [Tr. p. 218.] Consider the following testimony from Transcript pages 227-230:

> "Q. Mr. Breese, you said you were familiar with Defendant's Exhibit "C" for identification, which is that client's card. A. Yes, I have seen that before.
>
> Q. Did you ask for the client's cards? A. Never.
>
> Q. Were you ever refused the client's cards? A. Never. I never asked.
>
> * * * *
>
> Q. First of all, if you were present when Mrs. Lewin and Mrs. Baerlein were previously interviewed by the Internal Revenue Service. You indicated yes? A. I was.
>
> Q. At that time, during the course of the interviews, were you aware of the existence of the

cards reflected and similar to Defendant's Exhibit C for identification? A. Yes, they had told us of such cards—

Q. And did they discuss with you and Mr. Donley, or with Mr. Phoebus—either one—the use of those cards and what entries were made on them? A. Yes, they told us that.

Q. Are you mindful of the fact, Mr. Breese, that the clients' cards, much like a patient's card, dentist's card or doctor's card, contained the financial history or the relationship—financial relationship between Dr. Roy and the individual client? A. Well, I don't know what his relationship was, but I do know what the cards contained from only what the girls had told us.

Q. But you did not ask for those cards? A. I did not.

Q. So you do not know, or is it correct to state, Mr. Breese, that you do not know whether or not Mr. Roy's records are or are not adequate? A. I do not know."

(The preceding question is amplified so that the question indicates whether the books and records were adequate for the determination of income).

"Q. Is that correct, Mr. Breese? A. Well, the records that he had furnished to us were not adequate.

Q. Did you ask him for these cards? A. Not for these cards.

Q. You knew the meaning of these cards after being a participant at the interview of the witnesses? A. Yes.

Q. Mrs. Baerlein and Mrs. Lewin? A. Yes."

Mr. Donley also testified that he had never asked for the client account cards of the defendant. Mrs. Lewin and Mrs. Baerlein had informed him of the fact that they kept open accounts on each client. [Tr. p. 350.]

The testimony produced at trial, and enumerated above, clearly indicates that the defendant had books and records from which his true taxable income could have been ascertained. The investigating agents never sought to make use of the available records. They attempted to prove through the use of circumstantial evidence that income had been omitted and that such income had been omitted with fraudulent intent. It is true that the record does not disclose the defendant's attempt to *force* the records which would truly reflect his income upon the investigating agents, and their subsequent refusal to accept such records. Is any taxpayer so obligated? At the inception of the audit the defendant disclosed income omitted from his tax return. After undergoing a brief period of interrogation, he was next confronted by two agents who immediately stated that they were investigating "fraudulent intent" and then asked for records detailing his bank deposits. He produced those records in a sporadic manner. Mr. Roy then attempted to trace the deposits by indicating the source and character of each deposit. It appears that the investigating agents had predetermined their method of investigation, and immediately set about to develop a bank deposit case. It is neither logical nor sound as a matter of policy to require the defendant in a potential criminal case not only to comply with the requests of the investigating agents, but also to force upon them the records which he feels may be more pertinent.

### D. Dangers of Bank Deposits Method.

The most obvious dangers arising through the use of the bank deposits method as circumstantial evidence to prove omitted income are the possibilities that inter-bank transfers will be ignored, and that bank deposits which are not items of taxable income will be so included. Consider the thoroughness of the investigation in this case. [Agent Donley, Tr. p. 344]:

> "Q. Could you tell us with respect to the, to your investigative work, and with respect particularly to your own knowledge, whether deposits made in any bank bearing Dr. Roy's name, other than in Los Angeles, was not in fact picked up in deposits in Los Angeles bank accounts?
>
> The Court: Do you understand the question?
>
> The Witness: Yes, sir, I do, I personally could not as—as to the composition of funds going in this account I do know where they came from. I can trace them. But going beyond this account I don't know."
>
> Mr. Hochman:
>
> "Q. So you don't know one way or the other? A. That is correct."

The testimony of Agent Breese also reflects upon the thoroughness of the investigation [Tr. p. 226]:

> "Q. Can you tell us as to whether, in terms of your knowledge and your audit, do you know or do you not know whether or not the money that other witnesses and exhibits have talked about with respect to the Berliner Disconto account, are or are not reflected in deposits to accounts here in the name of Henry Roy, in personal capacity or in his trustee capacity? A. I can't state that.
>
> Q. In other words, you can't state it either way ? A. I cannot, that is correct."

The above testimony is particularly enlightening in view of the fact that the defendant apparently made statements to the investigating agents which they, and the Court, considered to be untrue with respect to the Berlin bank accounts. However, the Government has not proved that the Berlin bank accounts represent fees which were not subsequently deposited in bank accounts in the city of Los Angeles, and thereafter reflected in the cash receipts, or disclosed to Agent Breese as omitted income at the inception of the audit.

The transcript discloses that the defendant spent months tracing deposits [Tr. pp. 302-303], attempting to ascertain their source and character at the agents request. The correct figures of income were available within his books and business records and the above work was not only inaccurate, but unnecessary. The Court can well note the strain accompanying an Internal Revenue investigation, particularly when the taxpayer has acknowledged and previously disclosed gross receipts which are not reflected on his tax return. If the investigation had proceeded properly, the agents would have asked for all books and records which reflect items of receipt, whether considered taxable or tax-free by defendant, *rather than request records from which to reconstruct those figures actually reported on the tax return.* If the agents had requested and received those records, there would have been undisputed records disclosing the fees received. The bank deposits are in fact irrelevant for the purpose of ascertaining income in this case, and the taxpayer would have been relieved from the onerous task of disclosing bank accounts and analyzing the receipts therein during a three year audit. The taxpayer at all times contended that

only a portion of the bank account deposits constituted taxable income, and a proper investigation would have concerned itself with fees received, rather than with taxable vs. non-taxable bank deposits. It is suggested that the information requested by the agents and hesitantly supplied by the defendant was irrelevant, and that misstatements of fact or opinion would not have been forthcoming were the taxpayer not required to undergo the stress of supplying unnecessary information.

## II.

## WILLFULNESS.

The appellant contends that there is insufficient evidence to sustain a finding of willfulness within the meaning of Section 7201 of the Internal Revenue Code of 1954, 26 U.S.C. 7201. A finding of willfulness is one of the required elements of the crime charged in the indictment. In the context of the statute, that term means bad purpose, evil motive and an act done with the specific intent to accomplish that which the law forbids. *United States v. Murdock* (1933), 290 U.S. 389, 394, 395, 54 S. Ct. 223.

Appellants' contention is based on the fact that the record of this case discloses a complete lack of evidence of willfulness such as was indicated in the case of *Spies v. United States* (1943), 317 U.S. 492, 499, 63 S. Ct. 364, 368. In the *Spies* case, *supra,* the Supreme Court of the United States, in effect, stated that it considered evidence of willfulness to be:

> ". . . conduct such as keeping a double set of books, making false entries or alterations, or false invoices or documents, destruction of books or records, concealment of assets or covering up sources

> of income, handling of one's affairs to avoid making the records usual in transactions of the kind, and any conduct, the likely effect of which would be to mislead or to conceal. . . ."

Although the above examples were ". . . By way of illustration and not by way of limitation . . .," there is not present in this case any such conduct. There was only (1) set of books present in this case, a set which the Internal Revenue Agents chose to ignore. There were no false entries on the said records or alterations thereof. There were not "false invoices or documents" nor was there any "destruction of books or records." Indeed the taxpayer presented all his records dating back to year one—in this case 1949. [Tr. p. 467.]

The appellee has attempted to argue in the Court below that the appellant had "concealed his assets or covered up sources of his income", *i.e.* the so-called "Berlin bank accounts", claiming that these accounts were not disclosed to the Internal Revenue Service. This argument is irrelevant in the present case by reason of the fact that the Internal Revenue Service was computing taxable income by means of the bank deposits method of computing taxable income. [Tr. pp. 343, 344.] This being the case, it was incumbent upon the appellee to prove that the funds in these Berlin bank accounts were not also included in the American bank accounts, and thereby not reported as income. This the appellee could not do and such fact was admitted by Special Agent James Donley on cross-examination. [Tr. p. 344.]

It is difficult to see how the failure to supply the detailed records on the Berlin bank accounts can be

viewed as indicating intent to defraud, when considering the Government's position that the Berlin bank accounts were not reported on the tax return, and the expressed purpose of the audit was to "reconstruct the tax returns."

Note that in the testimony of Mr. Breese, there is no statement as to a request for *any* records. He does state that near the conclusion of his first interview Mr. Roy made available to him his cash receipts book, and Mr. Breese took a few notes from that book reflecting items of unreported income. [Tr. pp. 214, 215.] Special Agent Donley requested the records in the following manner [Tr. p. 279]:

> "I had explained to Dr. Roy that what we would like to do would be to *reconstruct his income as filed on the returns,* and in connection with that he gave me his—it was a summary of cash receipts which—not cash receipts exactly, it was a summary of receipts that had been deposited into his personal business account. He also gave me—this is for '56 through '60. He also gave me copies of the cash disbursements records, or check registers of '56 through '60.

On cross examination he describes his request as follows [Tr. p. 352]:

> "When I first interviewed Dr. Roy I told him that I would need records, *the same records that he used to prepare his returns.* And at that time that is when he gave me his cash deposits book, the total of which agreed with the amounts reported on the '56 return."

Agent Donley also stated that Dr. Roy had said, "That from the records that we had that we could re-

construct the returns just exactly like the one he had given us." [Tr. p. 281.] This statement is true in all respects. It follows the agent's request for books and records from which to reconstruct the income tax return. The three investigating agents failed to state during the trial that they had ever requested records reflecting all receipts from fees, or all receipts of any nature, or all items of taxable and non-taxable income, or any similar request.

The investigating agents were put on notice as to the nature of Mr. Roy's income at the beginning of the audit. At Transcript pages 210, 211, Revenue Agent Breese states that Mr. Roy told him that he had unreported income at the inception of his initial interview. He also stated that he had previously reported items similar in nature to that omitted on the tax returns under audit. Mr. Roy said that he collected as his fee a percent of the awards, *i.e.*, indicated that there was a contingent fee arrangement. Mrs. Lewin describes how Mr. Roy claimed only a percentage of his expenses on his Federal income tax return. [Tr. pp. 130-134.] Agent Phoebus stated that Dr. Roy told him that *German attorneys* retained a portion of the fee. [Tr. p. 259.] The above statements, along with taxpayer's books and records, clearly advised the investigating agents at the beginning of the investigation as to the sources and nature of all of Mr. Roy's income.

There are indications in the transcript that the defendant made false statements concerning the Berlin bank accounts. These statements were made approximately two and one-half years after the investigation began. It is significant to note the circumstances leading up to these false statements.

During Mr. Donley's first visit with Mr. Roy, he testified that:

> "I explained to Dr. Roy that I was taking Special Agent Phoebus' place in the investigation, that I was primarily *concerned with whether or not there was a criminal intent with regard to the unreported income* that he told Mr. Breese about." [Tr. p. 276.]

Prior to that meeting Mr. Roy had described the nature of his business and disclosed that he had substantial unreported income. The investigating agents then proceeded to put Mr. Roy to work in reconciling the bank deposits to his trustee and personal accounts, requiring that he indicate the character of each deposit, and admit the taxability thereof. [Tr. pp. 221-225.] This reconciliation was subsequently used during the trial for establishing an understatement of income and to establish willfulness. However, the reconciliation was for the purpose of reconciling the defendant's tax return, rather than ascertaining his tax liability. It is apparent that the longer the investigation proceeded, the more futile and ineffectual were the agent's efforts, and the more discouraged and scared became Mr. Roy.

It is also significant to note that the defendant clearly and honestly believed that the funds received from the awards were held initially in a trust capacity [Tr. pp. 81, 104], that refunds were made to clients from these accounts [Tr. p. 125], and that the bank accounts in Germany were attached pursuant to German court proceedings on September 3, 1963. [Tr. pp. 405-411.]

The Government cannot prove the essential element of willfulness by the introduction of evidence leading to speculation of fraudulent intent, but must prove this element of the crime beyond a reasonable doubt. Appellant submits that the Government has not met its burden of proof.

## III.
## CONCLUSION.

This case has great importance! It affords this Honorable Court the opportunity to delineate the guidelines for tax investigations of a criminal nature when they deal with "adequate" and "accurate" books and records.

The *Holland* decision permits the Government to proceed on alternate methods of computing taxable income, *i.e.*, net worth and bank deposits, because though books and records exist, ". . . many items of income had disappeared before they had even reached the recording stage . . ." and, because the books were ". . . more consistent than truthful."

This is appropriate in its own context. However, where the books and records are adequate and accurate we suggest that alternate methods are not employable. In the case at bar the defendant, rightly or wrongly, made an allocation between non-taxable and taxable receipts. Other than in 1960, this was not done on the face of the return. However, expenses were similarly allocated, *i.e.*, between deductible and non-deductible—following the same ratio of taxable and non-taxable receipts, and this was revealed within the four corners

of the income tax returns. More important, the defendant voluntarily revealed his treatment and allocation to the revenue agent at the very outset of the audit and investigation.

In this frame of reference, should the Government be permitted to ignore the books and records and conduct a lengthy and unusual (to a taxpayer with adequate and accurate records) audit and investigation, and further be permitted to use alternate methods fraught with their own dangers?

From the viewpoint of the taxpayer it borders on the incredible for the Government to pursue an investigation that virtually ignores the fountainhead and source of information, namely, the underlying records. This indirect method must breed distrust and creates a charged atmosphere in which cooperation will collapse. Had this audit been properly handled the taxpayer-defendant could not have made damaging admissions which admissions were generated in a hostile environment.

The taxpayer paid salaries to many employees for the principal purpose of having records and data for his own clients, but for the secondary purpose of having a set of books to be audited. To this day no such audit has been conducted by the Government. Unless and until the agents or other professional witnesses of the Government can testify that the records are inadequate and inaccurate, the bank deposit method should not be allowable. The *Holland* case approves of the bootstrap approach, to wit: allowing the use of a circum-

stantial method to prove its need. However, inherent in that opinion is the underlying assumption that the taxpayer's books and records were unavailable (Fifth Amendment umbrage) or were not truthful. In this regard it was assumed by the Holland Court that the agents audited what records were available. Nothing detracts from the obligation of the agents to audit records maintained in the normal course of business. There is no bootstrap operation in this case; there is rather a unilateral determination to use the bank deposit method notwithstanding the veracity and integrity of the books and records. In order to avoid paying more than lip service to the fears of the use of circumstantial evidence in a criminal tax case, this Court should clearly reaffirm the proposition that the Government must audit what is available before proceeding to alternate theories.

The use of circumstantial evidence should be a secondary approach rather than a primary audit technique. Picture, if you will, the posture of the present case were this done:

1. The evidence would show the books were accurate and adequate.
2. There would be a difference between taxable gross receipts and gross receipts per return.
3. This difference was explained by the taxpayer in terms of an erroneously believed legal interpretation.
4. The treatment of deductions followed the taxpayer's treatment of income.

In this context the discussions with the taxpayer are minimal, if any, and the Government would be hard pressed to even establish civil fraud. *The whole area of intent would remain limited to belief at the time the return was filed, rather than being extrapolated from post-return discussions unnecessarily generated by the indirect approach.*

The bank deposit method is no substitute for primary auditing. Taxpayers should be protected from lengthy harassment, however inadvertent, necessitated every time indirect methods are employed.

Respectfully submitted,

HOCHMAN & SALKIN,
*Attorneys for Appellant.*

## Certificate.

I certify that, in connection with the preparation of this brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those Rules.

BRUCE I. HOCHMAN,

# APPENDIX.

## Table of Exhibits.

| Exhibit | Identified | Offered | Received |
|---|---|---|---|
| 1 to 74, inclusive | 44 | 44 | 44 |
| 75 | 49 | 308 | 308 |
| 76 to 81, inclusive | 43 | | |
| 82 | 358 | | |
| 83 | 366 | 366 | 367 |
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